No. 12060

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ANNA HARRIS and MORRIS HARRIS,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONERS.

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Jurisdiction.

This petition for review involves deficiencies in Federal income and victory taxes for the years 1943 and 1944 in the total amount of $23,799.40 as to petitioner Anna Harris [Tr. 71], and $24,728.97 as to petitioner Morris Harris. [Tr. 72.] The cases of the two petitioners involve identical issues and were consolidated for hearing before The Tax Court of the United States, hereinafter referred to as the "Tax Court." The decisions of the Tax Court determining said deficiencies were entered May 12, 1948. [Tr. 71-72.]

This petition for review was filed August 4, 1948 [Tr. 164] pursuant to the provisions of sections 1141 and 1142 of the Internal Revenue Code, 26 U. S. C. A., sections 1141 and 1142.

Opinion Below.

The only previous opinion rendered in this cause is the opinion of the Tax Court [Tr. 51-71] reported in 10 T. C. ....., No. 109.

Issues Involved.

There are two issues involved:

(1) Did respondent err in ignoring a partnership consisting of petitioners and their children wherein assets were owned and profits and losses were divided on the following basis:

Morris Harris	7/16ths
Anna Harris	7/16ths
Albert P. Harris	1/16th
Betty Harris	1/16th

and in taxing all of said partnership income for the years in question equally to petitioners.

(2) In determining their 1943 victory tax liability, are petitioners entitled to deduct all or any part of the California State income tax paid by them during said year 1943?

Statutes and Regulations Involved.

Internal Revenue Code (26 U. S. C. A.)

"SEC. 22. GROSS INCOME.

"(a) General Definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such President and judges are hereby amended accordingly. In the case of judges of courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income."

"SEC. 181. PARTNERSHIP NOT TAXABLE.

"Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

"SEC. 182. TAX OF PARTNERS.

"In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * * * * *

"(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b)."

"SEC. 451. VICTORY TAX NET INCOME.

"(a) Definition.—The term 'victory tax net income' . . . means . . . the gross income . . . minus the sum of the following deductions:

* * * * * * * *

(3) Taxes. Amounts allowable as a deduction by section 23(c), to the extent such amounts are paid or incurred in connection with the carrying on of a trade or business, or in connection with property used in the trade or business, or in connection with property held for the production of income."

"SEC. 23(c)

"Taxes Generally—

"(1) Allowance in general.—Taxes paid or accrued within the taxable year, except—

"(A) Federal income taxes;

"(B) war-profits and excess profits taxes imposed by Title II of the Revenue Act of 1917, Title III of the Revenue Act of 1918, Title III of the Revenue Act of 1921, section 216 of the National Industrial Recovery Act, section 702 of the Revenue Act of

1934, or Sub-chapter E of Chapter 2, or by any such provisions as amended or supplemented;

"(C) income, war-profits and excess-profits taxes imposed by the authority of any foreign country or possession of the United States, if the taxpayer chooses to take to any extent the benefits of section 131;

"(D) estate, inheritance, legacy, succession, and gift taxes;

"(E) taxes assessed against local benefits of a kind tending to increase the value of the property assessed, but this paragraph shall not exclude the allowance as a deduction of so much of such taxes as is properly allocable to maintenance or interest charges; and

"(F) Federal import duties, and Federal excise and stamp taxes (not described in subparagraph (A), (B), (D), or (E)), but this subsection shall not prevent such duties and taxes from being deducted under subsection (a)."

Regulations 111.

"Reg. 111, Sec. 29.451-2.

"(2) Taxes.—Taxes deductible under 23(c) allowable for Victory Tax purposes if, and only if, paid or incurred—

"(i) in connection with the carrying on of a trade or business;

"(ii) in connection with property used therein; or

"(iii) in connection with property held for production of income."

Statement of Facts.

This proceeding was submitted to the Tax Court on the pleadings, oral testimony offered by the petitioners, and exhibits introduced in evidence at the hearing. *The respondent introduced no evidence.*

The facts here involved may be summarized as follows:

(1) The Union Manufacturing Company, the principal place of business of which is now located in Los Angeles, California, was founded in 1909. [Tr. 82.] It was and is engaged in the business of manufacturing men's work and sport clothes. [Tr. 83.] For a period of time and in particular during the war years, its business was substantial. [Tr. 109-111.]

(2) Union Manufacturing Company originally consisted of a partnership between one of the petitioners herein, Morris Harris, and Mr. Pinkert, the father of the other petitioner, Anna Harris. [Tr. 82.] The petitioner Anna Harris worked part time in the business from the time she attained high school age. [Tr. 82.] After she finished high school she gave her entire time to the partnership conducted by Morris Harris and her father, performing responsible functions. [Tr. 82-83.]

(3) Petitioners were married in 1919 [Tr. 82] and petitioner Anna Harris continued to work full time in the business until the birth of her first child. Even after the children were born she gave a substantial part of her time to the business, coming regularly to the office and performing important and vital functions. [Tr. 83-84.]

(4) The partnership between petitioner Morris Harris and Mr. Pinkert was terminated at the end of 1923. [Tr. 83.] A new equal partnership was then formed be-

tween the two petitioners herein which began operations January 1, 1924. [Tr. 83-84.] The partnership agreement is in evidence as Petitioners' Exhibit 3. [Tr. 137-138.] After the formation of said partnership petitioner Anna Harris continued to perform vital services for the enterprise. [Tr. 84.]

(5) Two children were born to the petitioners herein, Albert P. Harris, born June 14, 1923, and Betty Harris, born September 22, 1926. [Tr. 84.] The partnership agreement of 1924 expired according to its terms at the end of ten years. It was renewed by another document in writing dated April 1, 1937. [Tr. 85, Pet. Ex. 4.] This agreement remained in effect until January 1, 1943 when it was supplanted by a partnership agreement between the two petitioners and their two children to be hereinafter referred to. [Tr. 85.]

The existence of an equal partnership between petitioners herein up to January 1, 1943 was recognized by the Tax Court in its opinion below. [Tr. 51.]

(6) Albert F. Harris early took a real interest in the business and always intended to become an active member of the enterprise. [Tr. 86 and 116-117.] When petitioners were considering the sale of the business in 1937, Albert expressed opposition because he had always hoped to join his parents in its operation. [Tr. 86.] As a result the proposed sale was abandoned. [Tr. 86.]

(7) Albert worked in the business after school and during vacation periods while in high school. [Tr. 91 and 115-116.] He finished high school in June, 1941, and requested permission to immediately enter the business without attending college. With difficulty petitioners persuaded him to enter college on the representation that he

would be of more value to the business with further schooling. [Tr. 86 and 116.]

(8) In accordance with his understanding with petitioners, Albert entered the University of Virginia in the fall of 1941, after having worked during the summer vacation in the business. During this first school year he took the general college course. [Tr. 86 and 115.]

(9) Upon his return to Los Angeles in June of 1942 Albert again asked for permission to enter the business full time. During the summer of 1942 he worked full time in various departments of the business, performing substantial services, and at night attended the University of Southern California where he took specialized courses dealing with textiles. [Tr. 87 and 116-117.] During said summer the formation of a partnership between petitioners and Albert was discussed. In connection therewith petitioners consulted their attorney. [Tr. 87-88.]

(10) In the fall of 1942 petitioners, by promising Albert an interest in the business, were able to persuade him to continue his specialized training in textiles begun at the University of Southern California in the summer of 1942. Accordingly, in September, 1942, Albert entered the Textile School of the University of North Carolina, at Raleigh, North Carolina. [Tr. 87 and 117.]

(11) During the Christmas holidays of 1942 Albert again returned to Los Angeles and at that time the partnership between petitioners herein, Albert and Betty was definitely agreed upon. Albert received a *sixteenth* interest in assets and profits and losses of the business, and Betty the same. [Tr. 87-88 and 117-118.] Betty was included at that time in order to avoid the appearance of favoritism and with the hope that she might eventually take an active part in the business. [Tr. 88.]

(12) The partnership formed at Christmas 1942 was not reduced to writing, the parties' attorneys having advised them that a writing was unnecessary. [Tr. 89.] The agreement of the parties with respect to the partnership, however, was clear, definite, and unequivocal. [Tr. 88-89, 117-118, and 120.] There was no restriction as to the powers, rights of withdrawal, etc. of any of the partners [Tr. 89.] *In connection with the formation of said partnership income taxes were not considered or discussed.* [Tr. 106.]

(13) At the conclusion of the Christmas holidays his partners requested Albert to return to school, believing that he as a partner could be of best use to the partnership by increasing his specialized knowledge of textiles and their manufacture. [Tr. 116-118.]

(14) In the meantime in anticipation of the draft Albert had enlisted in the United States armed forces and was expecting a call to active duty after he returned to college. [Tr. 92 and 117.] He was called into active service in April, 1943 [Tr. 92 and 118] and remained in active service until January, 1946. Upon his discharge he went immediately into the business and has devoted his full time continuously thereto, performing at all times responsible functions. [Tr. 92-93 and 119.]

(15) As required by law, petitioner Anna Harris filed a gift tax return, Form 709, showing the gift to Albert during 1943 of a one-sixteenth interest in the assets of Union Manufacturing Company. [Tr. 94 and 149-151.] A donee gift tax return, Form 710, was duly filed by Albert covering said gift. [Tr. 95 and 151.] Likewise Morris Harris filed a gift tax return, Form 709, showing the gift to Betty during 1943 of a one-sixteenth interest in the assets of Union Manufacturing Company. [Tr.

95 and 152.] A donee gift tax return, Form 710, was duly filed by Betty covering said gift. [Tr. 95 and 152.] The returns referred to are in evidence as Petitioners' Exhibits 7, 8, 9 and 10. [Tr. 149-152.]

(16) Respondent audited said gift tax returns herein referred to and by letter dated September 25, 1945, increased the values placed upon the gifts made by petitioners herein and demanded and received from petitioners additional gift taxes. [Tr. 96 and 152-153.]

(17) Capital accounts were set up on the books of Union Manufacturing Company showing the interests in the partnership assets of the four partners, including Albert and Betty. Petitioners' Exhibits 12, 13, 14 and 15 are the ledger sheets showing the capital accounts of Morris, Anna, Albert and Betty Harris, respectively. [Tr. 100-101 and 154-157.] In said ledger sheets it is inadvertently shown that Albert was the donee of his father and Betty the donee of her mother [Tr. 127-128], although in fact and as shown by the gift tax returns, Albert was the donee of his mother and Betty the donee of her father. [Tr. 94-95.] The error is immaterial, however, as the amounts involved were identical. [Tr. 128.]

(18) According to page 40 of the General Journal of Union Manufacturing Company the entries opening new capital accounts for Albert and Betty and charging the capital accounts of petitioners herein were made September 16, 1943, as of January 1, 1943. [Tr. 102.] The delay in making appropriate entries was due to an oversight

on the part of the interested parties, each believing that someone else had attended to it. [Tr. 103.]

(19) At the end of each of the years 1943 and 1944 one-sixteenth of the earnings of the business was credited to the capital accounts of Albert and Betty, respectively. Their withdrawals (for Federal income taxes) were charged to their capital accounts. [Tr. 128-129 and 156-157.]

(20) Federal partnership returns, Form 1065, were filed for each of the calendar years 1943 and 1944 for Union Manufacturing Company. These returns showed Albert P. and Betty Harris as partners with the petitioners herein in the following proportions:

Morris Harris	7/16ths
Anna Harris	7/16ths
Albert P. Harris	1/16th
Betty Harris	1/16th [Tr. 93-94.]

Said returns are in evidence as Petitioners' Exhibits 5 and 6. [Tr. 139-148.]

(21) In auditing the returns of petitioners herein for the calendar years 1943 and 1944 respondent ignored the partnership formed January 1, 1943, and charged to petitioners herein equally the income belonging to and reported by Albert P. and Betty Harris.

(22) During the calendar year 1943 petitioner Morris Harris paid to the State of California personal income tax in the amount of $26,746.65. [Tr. 80.] The return showing said tax is in evidence as Petitioners' Exhibit 1. [Tr. 130-134.] During said year petitioner Anna Harris

paid to the State of California personal income tax in the amount of $25,256.18. [Tr. 81.] The return showing said tax is in evidence as Petitioners' Exhibit 2. [Tr. 134-136.] As shown by said exhibits, substantially all of said tax resulted from the inclusion in petitioners' taxable income of the income accruing to them from the Union Manufacturing Company.

(23) Petitioners in computing their liability for Victory Tax for the calendar year 1943 deducted the amounts paid to the State of California as personal income taxes as set forth in the preceding paragraph hereof. Respondent disallowed said amounts as deductions in computing said Victory Tax.

(24) The facts as found by the Tax Court [Tr. 52-59] are at variance with those stated hereinabove only in the lower court's conclusion that (1) neither of the children contributed any capital of their own [Tr. 58]; (2) Albert's services prior to 1943 were not substantial [Tr. 58); (3) neither of the children withdrew any amounts from the partnership during 1943 and 1944 [Tr. 58]; (4) no new and bona fide partnership was formed in 1943 [Tr. 59]; and (5) petitioners Anna and Morris Harris were the only partners during 1943 and 1944. [Tr. 59.] The Tax Court also failed to find that in returning to textile school in January, 1943 at the request of his partners *Albert was, in fact, performing vital services for the partnership.*

(25) The Tax Court sustained the respondent on both issues as to both petitioners. The petition for review herein followed.

Specification of Errors.

(1) The Tax Court in its Findings of Fact made no finding as to whether or not completed gifts of interests in the partnership theretofore conducted by petitioners were made by petitioners to their two children.

If the Tax Court's opinion is to be read as containing a finding that no such valid gifts were made, then such finding is totally without support in the evidence and the Tax Court erred in that particular.

(2) The Tax Court erred in failing to find or conclude that there was in existence throughout the years 1943 and 1944 a bona fide partnership consisting of Anna Harris, Morris Harris, Albert Harris, and Betty Harris, and that said partnership should be recognized for Federal income tax purposes.

(3) The Tax Court erred in failing to find or conclude that the California income taxes paid by the petitioners during the year 1943 were deductible by said petitioners in computing their respective victory tax net incomes for said year.

Summary of Argument.

The argument herein will, of course, be divided into two parts, the first relating to the partnership issue and the second to deductibility of California income taxes in computing victory tax net income. The first applies to both years involved—1943 and 1944; the second applies only to the year 1943.

(1) On the first issue petitioners contend as follows:

(a) Bona fide gifts of interests in the partnership were in fact made by petitioners to their two children effective January 1, 1943.

(b) The partnership consisting of petitioners and said two children must be recognized for Federal Income tax purposes because said partnership was not formed for the purpose of dividing family income and thus reducing the income taxes of the family group but was a bona fide business arrangement whereby the parties really and truly intended to carry on business together as partners within the rationale of the decisions of the Supreme Court in the cases of *Commissioner v. Tower,* 327 U. S. 280, 66 S. Ct. 532, and *Lusthaus v. Commissioner,* 327 U. S. 293, 66 S. Ct. 539, to be hereinafter referred to.

It will be shown that it is the *intention of the parties* which is controlling, and not the presence or absence of any particular element such as the contribution of capital or the rendering of vital services. It will be pointed out that the *record* clearly reveals the bona fides of the partnership and *contains no evidence in support of the Tax Court's conclusion that there was no valid partnership for Federal income tax purposes.*

(2) On the second issue, it is petitioners' contention that the clear language of the statutes permits the deduction of California income taxes in computing victory tax net income. The only requirement of the statute, as set forth above, is that the taxes were paid or incured in connection with the carrying on of a trade or business. The California income taxes paid by the petitioners were paid on and by reason of income earned in their business, hence were paid in connection with the carrying on of that business and are deductible in arriving at victory tax net income.

Outline of Argument.

A. On January 1, 1943 valid gifts of interests in the then existing partnership of Union Manufacturing Company were made by the then partners, petitioners herein, to their two children.

B. The partnership effective January 1, 1943, between petitioners herein and Albert and Betty Harris was valid and should be recognized for Federal income tax purposes.

C. Income taxes paid to the State of California during the year 1943 are deductible in determining petitioners' respective victory tax net incomes for that year.

ARGUMENT.

A. On January 1, 1943 Valid Gifts of Interests in the Then Existing Partnership of Union Manufacturing Company Were Made by the Then Partners, Petitioners Herein, to Their Two Children.

Petitioners in the "Statement of Facts" heretofore set forth in this brief specifically enumerated the circumstances connected with the gifts by petitioners on January 1, 1943 of a one-sixteenth interest in the assets and business of the Union Manufacturing Company to petitioners' two children.

The Tax Court in its Findings of Fact makes no specific finding with respect to the validity of said gifts. In its Opinion, which is at best confused, the Tax Court intimates that bona fide gifts of interests in said partnership may not have been made by petitioners to their two children.

It is respectfully submitted that the Tax Court erred in not making a specific finding on this point in its Findings of Fact.

On the other hand, if the Court's Opinion (as opposed to its Findings of Fact) is to be deemed to constitute a finding against petitioners on this point, then the Tax Court erred in making any such finding as *there is no evidence of any kind or nature in the record to support any such conclusion.*

The facts as clearly and unequivocally established by the record show the following:

(1) Both petitioners testified without contradiction that gifts of an interest in the assets and business of the partnership were made by them to their two children as of January 1, 1943.

(2) Federal gift tax returns both in behalf of the donors and the donees showing such gifts were filed with respondent herein and duly audited by him.

(3) The values of said gifts at the date thereof, January 1, 1943, were questioned by respondent upon his audit thereof and were substantially increased. As a result, respondent demanded and collected from petitioners additional gift taxes on account of said gifts.

(4) Proper and appropriate entries indicating the ownership by the children of a one-sixteenth interest each in the assets of the business as of January 1, 1943 were duly made on the books of the partnership. The income taxes of the two children were paid during each of the years in question from their interest in the assets of the business and their capital accounts were charged accordingly.

(5) Appropriate Federal income tax returns were filed for each of the years in question showing that the children were partners in said enterprise and in truth and fact owned an interest in the assets and business as indicated by the gift tax returns filed by petitioners herein.

(6) The children on their individual returns for the years in controversy included and paid tax on their distributable shares of said partnership income.

(7) The parties testified without equivocation that there was no restriction on the powers, rights of withdrawal, etc. of any of the partners, including specifically petitioners' children.

(8) There is absolutely not a shred of evidence in the record to justify a finding that bona fide gifts of interests in the business and assets of the Union

Manufacturing Company were not made by petitioners herein as of January 1, 1943 to their two children.

As a matter of fact, the Tax Court does not even attempt to justify its intimation that no completed gift was made. Certain comments of the Court [Tr. 66] are worthy of note:

(1) The Tax Court states that there was no written partnership agreement. It is too clear to require comment that the absence of a written agreement is not evidence that no completed gifts of partnership interests were made.

(2) It is stated that the "alleged verbal agreement was a loose one." There is absolutely no basis for any such statement. The parties testified that each child acquired a one-sixteenth interest in the assets and profits and losses of the business. That is clearly sufficient to establish a partnership. As a matter of fact, it is well known that most partners go no further in specifying their rights and duties one to the other.

(3) The Tax Court states that the "partnership books were not closed." There is absolutely nothing in the record to justify any such gratuitous statement. As a matter of fact, the evidence shows exactly the contrary, and above all, that the books of account of the partnership and the parties were at all times meticulously maintained.

It is true that the initial book entries setting up the children's accounts on the books of the partnership were not made until September 16, 1943 and then as of January 1, 1943. The parties testified, however, that that was due to an oversight and to nothing more in that the

interested parties each thought that some one else had attended to it.

It is respectfully submitted that if the Tax Court shall be deemed to have found as a matter of fact or law that no completed gifts were made by petitioners to their children of interests in the partnership in question, that such finding was arbitrary and totally without support in the evidence.

B. The Partnership Effective January 1, 1943, Between Petitioners Herein and Albert and Betty Harris Was Valid and Should Be Recognized for Federal Income Tax Purposes.

It would unduly prolong this brief to enter upon a detailed discussion of the many so-called family partnership cases. This argument will, therefore, be limited to a discussion of a few cases which we deem to be significant.

At the head of a long line of cases from the various courts stand *Commissioner v. Tower,* 327 U. S. 280, 66 S. Ct. 532, and *Lusthaus v. Commissioner,* 327 U. S. 293, 66 S. Ct. 539. These are the cases which expound the basic rule which the courts in all subsequent cases have attempted to apply to the facts before them. The rule may be very simply stated by the following quotation from the *Tower* decision:

> "When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both."

In the latter part of its decision in the *Tower* case, the Supreme Court acknowledged that a wife might, under

proper circumstances, he recognized as a bona fide partner. The court then enumerated certain tests, the absence of all of which "the Tax Court may properly take . . . into consideration in determining whether the partnership is real within the meaning of the federal revenue laws." The tests so enumerated are a share in the management and control of the business, the rendering of vital additional services, or the contribution of capital originating with her.

Ignoring the statement of the Supreme Court that the factors referred to above were merely *some* of the facts to be considered in arriving at an ultimate decision, the Tax Court, in a long line of cases decided subsequent to the *Tower* and *Lusthaus* cases, seized upon the presence or absence of the three above mentioned factors as *conclusive* in determining the validity of the partnership under attack. No attempt was made to independently determine the intent of the parties. As will be hereinafter pointed out, it has been but very recently that the Tax Court has apparently returned to the true test of intent.

The Federal District Courts and Circuit Courts of Appeal, however, have almost without exception read the *Tower* and *Lusthaus* cases as prescribing the rule of *intent*. Accordingly said courts have refused to apply blindly as conclusive tests the contribution of independent capital not originating with the parent and the performance of alleged vital services.

In three district court cases tried before juries, the juries were instructed that the question was whether the partnership was a genuine, bona fide, good faith organization, and whether the parties really and truly intended to carry on business as partners. The juries were instructed

that the presence or absence of a contribution of capital, a share in management, and vital services rendered by the questioned partner were merely elements to be considered in answering the ultimate question. In all three cases the juries found for the taxpayers. The cases are *Knott v. Allen,* U. S. D. C., M. D., Georgia (January, 1947), reported at paragraph 72,414 P-H Fed. 1947, affirmed by C. C. A. 5 in *Allen v. Knott,* 166 F. 2d 798*; Mallary, Jr., v. Allen,* U. S. D. C., M. D., Georgia (November, 1947), reported at paragraph 72,615 P-H Fed. 1947; and *Hager v. Kavanagh,* U. S. D. C., W. D., Michigan (December, 1947), reported at paragraph 72,462 P-H Fed. 1948.

Similarly, in *Cooke v. Glenn,* U. S. D. C., W. D., Kentucky (June, 1948), reported at paragraph 72,551 P-H Fed. 1948, the court, sitting without a jury, found for the taxpayer, based upon "the intention of the parties and their good faith in joining together for the purpose of carrying on business and sharing in the profit or loss."

Various of the circuit courts have also taken the same view as to the true meaning of the Supreme Court's pronouncements in the *Tower* and *Lusthaus* cases. A number of reversals of the Tax Court have resulted. Some of these cases merit a brief discussion.

In *Lawton v. Commissioner,* 164 F. 2d 380 (C. C. A. 6, November, 1947), the same judge who heard the instant controversy as a judge of the Tax Court had concluded that no bona fide partnership existed, in spite of the uncontradicted evidence of the petitioners that a partnership was intended and in fact existed. The Circuit Court reversed, stating that the undisputed and uncontradicted evidence of the parties may not be arbitrarily disregarded by the fact finder. The appellate court further gave im-

portance to the fact that the business was "a coordinated family enterprise" started by the father and mother "into which were integrated the sons and daughters as they came from school and college, to the extent that their training and abilities became useful." In short, the parties really and truly intended to do business as partners, regardless of capital contributions or the nature and extent of services rendered.

The Tax Court was again reversed in *Culbertson v. Commissioner,* 168 F. 2d 979 (C. C. A. 5, June, 1948; cert. granted, December, 1948), where the disputed partners had not contributed their own capital and had performed no services during the year in question because either in school or in military service. The opinion contains such an illuminating discussion of the principles applicable to these cases that it is deemed appropriate to quote extensively therefrom:

> "It was the purpose and intent of all the parties to form an actual, real, and bona fide partnership between Culbertson and his four sons, with the full expectation and purpose that the boys would, in the future, contribute their time and services to the partnership. *We do not consider that it is illegal, income-tax-wise or otherwise, for a partnership to be formed in consideration, or contemplation, of services rendered, or to be rendered, by the partners. The fact that the boys were called into the military service by the United States, as well as the fact that some of them had not, during the tax period, completed their education so as to devote their full time and attention to the partnership is in no wise indicative that the partnership was formed for the purpose of dividing the family income, or for the purpose of income tax savings.* The failure by a partner to render service

to the partnership or to contribute capital originating in him, is, after all, but a circumstance to be considered in determining the reality or actuality of an alleged family partnership. The failure to do either is not a condition precedent." (Italics supplied.)

* * * * * * * *

"In the cases of *Commissioner v. Tower,* 327 U. S. 280 (66 S. Ct. 532, 34 A. F. T. R. 799); and *Lusthaus v. Commissioner,* 327 U. S. 293 (66 S. Ct. 539, 34 A. F. T. R. 806), the court determined that the arrangements there were mere devices entered into for income tax savings and purposes and not for the benefit of the partnership. To conclude in this case that the plan and purpose of an aging father to enlist the interest and services of his four ranch-reared, experienced, and stalwart sons in the carrying on of his and his partner's life work was not for the partnership's benefit seems to require the exaltation of suspicion over the realities to an extent that the exigencies of the times for tax collection neither deserve nor demand."

* * * * * * * *

"It seems that out of the cases of *Lusthaus v. Commissioner, supra,* and *Commissioner v. Tower, supra* —which cases were properly decided on their peculiar facts—a *concept has been born and is carefully nurtured by the tax collecting agencies that no partnership is valid—income-tax-wise—between members of a family unless the members of the family coming into the partnership actually contribute money or had actually, theretofore, rendered services.* Neither statute, common sense, nor impelling precedent requires the holding that a partner must contribute capital or render services to the partnership prior to the time that he is taken into it.

"These tests are equally effective whether the capital and the services are presently contributed and rendered or are later to be contributed or to be rendered. Moreover, a partnership is formed to act in the future and not in the past and when it is fully expected, intended and agreed that the incoming partner will render services to the partnership, the Government should not be heard to say: 'I will not recognize you as a partner even though you in good faith entered into it. I took you into the Army to fight a war and you did not perform services for the partnership as you had agreed to do.'

"The inquiry as to a family partnership for income tax purposes must relate to evidence bearing on the reality, the actuality, and the bona fides of the transaction, or the absence thereof. Where the proof conclusively shows that a family partnership was entered into for the benefit of the business and not the purpose of evading, avoiding, or dividing, income taxes, it will be deemed a partnership for income tax purposes even as it is recognized in the law for all other purposes.

"Income generally should be taxed to him who owns it. The Culbertson boys owned one-half the cattle that produced the income here.

"Neither the Constitution, the statutes, nor public policy requires that partnerships between fathers and sons be outlawed or discouraged. The desire of a father in any age or clime, with a business that he cherishes and a son that he loves, to have such son with him in his business and to carry it on when he no longer can, was not rendered an anathema by the *Lusthaus* and *Tower* cases, and abberations from the salutary rules announced in those cases should not now do so." (Italics supplied.)

In *Kent v. Commissioner,* ..... F. 2d ..... (C. C. A. 6, September, 1948), the court commented on the Tax Court's attitude as follows:

> "The Tax Court's construction of the *Tower* and *Lusthaus* cases, above mentioned, as well as the line of cases leading to the rule therein announced, is that lack of material income-producing services by the wife, or of capital originating with the wife, is sufficient to negative any partnership agreement between husband and wife, even in the absence of a finding of an underlying motive of tax reduction.
>
> "However, in *Lawton et al. v. Commissioner,* 164 F. (2d) 380, this court held that these were only circumstances to be considered in determining whether family partnerships would be disregarded for tax purposes. . . ."

See also *Wilson v. Commissioner,* 161 F. 2d 661 (C. C. A. 7, April 30, 1947), where the following statement appears:

> "The *Tower* and *Lusthaus* cases delineate the tests to be applied in determining whether the family partnership is a genuine partnership for Federal income tax purposes. *These tests are merely to aid in the ultimate determination of the existence of an actual, bona fide partnership.* . . ." (Italics supplied.)

Recently, even the Tax Court has apparently begun to recognize the error of its ways and to embrace the views expressed by the foregoing cases. Thus, in *Isaac Blumberg,* 11 T. C. ....., No. 80 (October 25, 1948), that court approved the following as "a very good summary of the rationale of the Supreme Court's decision in the *Tower* and *Lusthaus* cases":

> "The test in determining the bona fide character of a family partnership is to ascertain whether the

> partners really and truly intended to join together for the purpose of carrying on a business and sharing in its profits, or whether the partnership was a mere sham utilized solely for the purpose of reducing a taxpayer's true tax liability by a pretended distribution of income."

Applying this test, the Tax Court recognized as a partner a son who contributed no capital of his own and who entered the armed services before the effective date of the partnership and rendered no substantial services during the taxable year.

In *William Collins, Sr.,* paragraph 48,241 P-H Memo T. C. (November 15, 1948), the court quoted with approval the foregoing statement from the *Blumberg* case and in *August J. Fischer,* paragraph 48,230 P-H Memo T. C. (October 25, 1948), the court referred to the "common sense proposition" that family partnerships are to be determined by the bona fides of the persons making up the partnership.

Accordingly, it seems crystal clear that the only question to be answered in this proceeding is: Did the petitioners and their children really and truly intend to join together for the purpose of carrying on a business and sharing its profits or losses, or was the arrangement merely a device for reducing income taxes?

The Tax Court in neither its Findings of Fact nor opinion made any specific finding as to the *intent* of the parties. Instead the court, in a confused opinion, appeared to question the validity of the initial gifts in one breath and to claim retention of control by petitioners in another.

The Tax Court dismissed the entire history of the parties, Albert's determination to enter the business, his special schooling to that end, his return to the business after discharge from the armed forces of the United States, all with the following statement:

> "There is no evidence to clearly show that the usual terms of a partnership agreement were worked out so as to definitely establish the rights and duties of the son if he were to really carry on a business in partnership with his parents during the taxable years. The only inference which can be made from the record is that management of the business was to remain in Morris Harris, and that he was to continue to control the business and the earnings, as far as his children might be concerned. Partnership books were not closed. There were only bookkeeping entries which served to provide the basis for allocating earnings to the young son who was in school, at first, and later in the Army."

With respect to the daughter, Betty, the Tax Court says [Tr. 64]:

> "There is no evidence that she desired to, or intended to, or did carry on the business enterprise in partnership with her parents in the taxable years. . . . There is no evidence of a completed transfer of an interest in the business to her such as would put her in complete dominion and control over an interest in the business and the earnings thereof. . . ."

With respect to Betty, the following should be noted:

(1) Petitioner Anna Harris testified at the hearing as follows [Tr. 88]:

"We also felt that as long as we were giving Albert a small share, just having the two children, we felt

it would be fair to give Betty the same share, and although she was very young, she always showed an interest. We felt that after her college, if she wasn't married, she would step in."

(2) Petitioners testified without equivocation that there were no restrictions as to the powers, rights of withdrawals, etc., of any of the partners. [Tr. 89.]

Against the Tax Court's meager and inadequate basis for striking down the partnership we may consider briefly the uncontroverted facts shown by the record. These facts show that the parties truly intended to enter into an honest, bona fide business relationship:

(1) We begin with an "integrated family enterprise" *(Lawton v. Commissioner, supra)*. Petitioners, although husband and wife, had admittedly been real partners in the business in question for more than 20 years prior to 1943.

Under the circumstances what could be more natural and logical than that the children should likewise come into the business in order to carry it on after their parents' retirement.

(2) As early as 1937 Albert had indicated an active interest in the business and a desire to some day join his father and mother in its conduct. A possible sale of the business in 1937 was abandoned at Albert's request even though he was then very young.

(3) The testimony is unequivocal that after school hours and during vacations Albert always worked in the business. Thus, by the time the partnership was formed he had acquired a substantial familiarity with its operations.

(4) On at least two occasions prior to the formation of the partnership under attack Albert had asked petitioners for permission to quit school and devote all his energies to the business. On each occasion he was advised to continue his education with the assurance that he would thus become more valuable to the business.

Six months before the partnership was formed he had begun to take specialized courses looking especially to his entry into the business then being conducted by petitioners herein.

He returned to college in the fall and winter of 1942 as a result of the promise that he would become a partner on January 1, 1943. In attending a highly specialized textile school at the request of his partners, *Albert was performing a partnership service just as surely as if he had been present in person at the partnership's principal place of business.*

(5) Immediately upon his discharge from the armed forces, Albert returned to the business and has since devoted all his time thereto and performed substantial, vital, and important functions.

(6) With respect to Betty, a somewhat different situation exists. While it is true that at the time of the formation of the partnership it was unlikely that she would within the near future devote all her energies to the business, it was perfectly natural that having included the son, for perfectly valid business reasons, the parties would likewise include the daughter for a small interest.

(7) Finally, two extremely important factors, both of which were completely ignored by the Tax Court, should be carefully noted:

(a) The interests given by petitioners to their two children were extremely small—1/16th each. The parents thus recognized the inexperience of their young partners. What could be better evidence of the good faith of the petitioners herein than that they limited the participation of their children to these very small interests.

(b) As a part of (a) above it should be noted that the parties specifically testified that in connection with the formation of the partnership in question income taxes were neither considered nor even mentioned. It is obvious that had the parties been interested in minimizing taxes their children would have received far more substantial interests than were in fact given.

It is respectfully submitted that the authorities already cited indicate beyond doubt the true test applicable in determining the validity of a family partnership, namely, the intent of the parties.

By the same token, we believe that the record shows beyond question that there was here a bona fide intent to enter into an honest business relationship on the part of petitioners and their children.

It follows that the Tax Court's decision on the point in question was in error and should be reversed.

One further factor might be here briefly noted. The court is not bound to conclude that either both or none of the two children were bona fide partners. If the court should determine that a true intent to enter into a bona fide business relationship with Betty was lacking, it does not follow that the same decision should apply to Albert.

C. Income Taxes Paid to the State of California During the Year 1943 Are Deductible in Determining Petitioners' Respective Victory Tax Net Incomes for That Year.

Section 451(a)(3), *supra*, provides for the deduction of taxes in arriving at victory tax net income to the extent such taxes are paid or incurred in connection with the carrying on of a trade or business. It is respectfully submitted that state income taxes paid upon income derived from the operation of a trade or business are paid in connection therewith. If there is no income there is no tax. If there is income, there is a tax. The tax is the direct result of the income and if that income is derived from the operation of a business the tax thereon must necessarily be incurred in connection with the carrying on of that business.

Webster's New International Dictionary, Second Edition (Unabridged) defines the word "connection" as: "Relationship by causality, mutual dependence, logical sequence, or the like; relation of things when one of them is involved in another." The relationship between income from a business and the California income tax thereon is certainly one of cause and effect and the tax follows the income in a logical sequence. The tax here involved was, therefore, clearly paid in connection with the trade or business of the petitioners.

An analogous situation exists in connection with the determination of "adjusted gross income" for income tax

purposes as distinguished from "net income" for such purposes. In arriving at the former certain deductions attributable to a trade or business are allowable. In arriving at the latter, further purely personal expenses are allowed as deductions. Different ultimate tax consequences may result from the classification of deductions for said purposes.

In I. T. 3829, C. B. 46-2, p. 38, the respondent himself ruled that the Indiana gross income tax is deductible in arriving at adjusted gross income to the extent such tax is paid by an individual taxpayer on gross income derived from a trade or business. The only difference between the definition of deductions allowed in arriving at adjusted gross income and of those allowable in arriving at victory tax net income is that the former uses the words "attributable to" rather than "in connection with" a trade or business. There appears to be no reason for giving a different definition to the two phrases. If state income taxes can be said to be attributable to business income, then they can just as logically be said to be paid in connection with such trade or business.

This appears to be a case of first impression on the subject with the result that there are no case citations which are helpful. It is, therefore, submitted that the plain language of the statute indicates that in arriving at a victory tax net income a deduction should be allowed for state income taxes to the extent paid on income derived from a trade or business.

Conclusion.

Petitioners respectfully submit that the decision of the Tax Court should be reversed in its entirety for the reasons that the partnership was bona fide and not a tax avoidance scheme and that the California income taxes paid during 1943 were incurred in connection with the petitioners' trade or business.

Respectfully submitted,

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